Nout Wellink: Basel III and the impact on financial markets

Speech by Mr Nout Wellink, President of the Netherlands Bank and Chairman of the Basel Committee on Banking Supervision, at the ING Basel III Financing Conference, Amsterdam, 14 April 2011.

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It is has been three and a half years since the global financial crisis began. The banking sector and financial system now seem to have stabilised. But this required unprecedented public sector interventions, and significant risks remain. Despite the severity of the crisis, we are already seeing signs that its lessons are beginning to fade. At the same time, there are still significant risks on the horizons, while key reforms still need to be carried through if we are to achieve a truly stable banking and financial system.

The Basel III framework is the cornerstone of the G20 regulatory reform agenda and the Basel Committee rules were issued at the end of last year. This development is the result of an unprecedented process of coordination across 27 countries. Compared to Basel II, it was also achieved in record time, less than two years. The next step, which is just as critical as the policy development, is implementation. Consistent and timely global implementation of the minimum standards of Basel III is critical to ensure longer-term banking sector and economic stability. Some countries may choose to implement higher standards to address risks particular to their national contexts, examples of which so far are Switzerland and Sweden. This has always been an option under Basel I and II, and it will remain the case under Basel III. To minimise the transition costs, the Basel III requirements will be phased in gradually from 1 January 2013.

This morning I would like to discuss with you the impact of Basel III on financial markets. In addition, I would like to focus on a key remaining area of policy development work, which is dealing with the risks of systemically important banks.

The liquidity framework

I am aware that the impact of Basel III on financial markets is especially interlinked with the new funding and liquidity ratios. Let me therefore first say a few words about new the liquidity standards. Weak liquidity profiles of banks were one of the core elements of the crisis, and they therefore represent a critical part of the regulatory framework going forward. Overall there is broad support for the liquidity framework introduced by the Basel Committee. Banks and other market participants already use methods similar to the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR). Many of the issues that have been raised pertaining to these requirements revolve around the calibration of the ratios, rather than the conceptual basis of the framework.

It is important to emphasise the goal in establishing the liquidity framework: to require banks to withstand more severe shocks than they had been able to in the past, thus reducing the need for such massive public sector liquidity support in future episodes of stress. The success of the framework should not be measured in terms of whether it will have zero cost. Instead, the better measure of success is whether the framework corrects pre-crisis extremes at acceptable costs. Banks that take on excessive liquidity risk should be penalised under the new framework, while sound business models should continue to thrive. With these objectives in mind, the Committee will use the observation period to review the implications of the standards – all the more as they are brand new – for individual banks, the banking sector, and financial markets, addressing any unintended consequences as necessary.

In this regard, the Basel Committee's focus is now on ensuring that the calibration of the framework is appropriate. Certain aspects of the calibration will be examined and this will involve regular data collection from banks. Any adjustments should be based on additional information and rigorous analyses. However, banks' data on the crisis are distorted because of the government support schemes. Hence, the analysis will need to include both quantitative bank experience and additional qualitative judgement.

It is worth emphasising that a number of effects of the framework are indeed intended. For example, with regard to the pool of liquid assets, the rules are meant to promote changes in behaviour and to create incentives to reduce risky liquidity profiles. This can be done, for example, by pushing out the average term of funding or increasing the share of stable funds. In other cases, banks did not price liquidity appropriately throughout the firm, and correcting risk management deficiencies will in turn improve liquidity profiles. In fact, the initial response we have observed in some countries that have already implemented comparable liquidity ratios suggest that these are the types of strategies that are being pursued.

Effects of Basel III on financial markets

Since the new regulation will change the behaviour of banks, it will also have wider effects on financial markets. The effects in the transitional phase will be different from the effects in the new steady state. In the transitional phase, adjustments of banks' balance sheets to meet the new capital and liquidity standards will affect supply and demand in capital markets and could lead to relative price changes.

Equity markets: impact of the new buffer regime

On equity markets, additional demand from banks is expected. The quantitative impact study by the BCBS shows that banks worldwide need additional capital of EUR 175 billion to reach a core capital ratio of 4.5% and around EUR 600 billion for the 7% requirement. For comparison, euro area bank equity issuance has been USD 20 to 50 billion annually since 2005. Mind that this includes the crisis period. The worldwide figure ranged from USD 50 to USD 150 billion. This suggests that, given enough time, markets should be able to absorb the new capital that needs to be raised. Especially if banks are able to use this time to accumulate capital through retained earnings and lower costs. This would reduce their need to go to the equity market.

Bonds markets: impact of Liquidity coverage Ratio (LCR)

The new liquidity requirements could influence fixed-income markets. The quantitative impact study by the BCBS shows that the shortfall of liquid assets to meet the LCR is around EUR 1.7 trillion for the worldwide banking sector [this figure does not include the surplus of banks that meet the LCR]. This seems high, but is less than 10% of the total market size of domestic liquid assets. Nevertheless, there may be some currency areas where the supply of liquid assets is smaller than in other areas. The new liquidity regulation provides for tailor made solutions in those cases. For instance, the Reserve Bank of Australia has established a liquidity facility to help local banks meet the LCR requirement, while Denmark intends to give special treatment to covered bonds; the possibilities to do so will be fleshed out over the observation period.

The LCR will change the relative preferences for banks to hold certain asset classes. It will make assets that are considered as liquid under the new regulation more popular, and assets that are not considered as liquid assets less so. This can shift demand to sovereign bonds, covered bonds and high quality corporate bonds and away from less liquid assets, such as other bank bonds, securitised assets and lower quality corporate bonds. All this can have implications for credit spreads and investors' returns on particular market segments.

The asset purchasing programmes of the US Federal Reserve give an indication of the effects of large-scale bond purchases on interest rates. The effects on the 10-year Treasury yield per USD 100 billion of asset purchases have been estimated to range between 2 and 7 basis points, which suggests a high degree of uncertainty. Moreover, these effects can not be translated one by one to the impact of the new liquidity regulation. The expected investments by banks will stretch over a much longer horizon than the asset purchases by the Fed. In any event, banks' reactions to the introduction of the new liquidity standards are uncertain. In addition to accumulating liquid assets, banks could also scale back business activities that are vulnerable to liquidity risk, or lengthen the maturity of their funding.

Bonds markets: impact of Net Stable Funding Ratio (NSFR)

The requirement to reduce the maturity mismatch via the NSFR will urge banks to look for more stable sources of funding. Since they will have to compete with other borrowers in the term funding markets, the additional demand by banks could drive up the yields on bank bonds. To limit funding costs, banks will pursue different strategies in their liquidity management. They will try to raise more retail deposits. However, the supply of retail savings is limited, in particular in the Netherlands where banks have to compete with insurance companies and pension funds. Alternatively, banks could issue more secured funding, for instance covered bonds, or issue more long-term unsecured bonds. To raise more unsecured long-term bonds, banks may have to rebuild their investor base, for instance through increased transparency. Stress-tests could contribute to that; they are a useful tool to disclose exposures to particular risks.

Reducing maturity mismatches to meet the NSFR is a big challenge for banks in the coming years. The study of the BCBS shows that the shortfall of liquid assets to meet the NSFR is around EUR 2.9 trillion for the worldwide banking sector [this figure does not include the surplus of banks that meet the NSFR]. This headline figure can not be simply totalled with the shortfall of the LCR that I mentioned before. A bank that meets the NSFR probably also meets the LCR. Another issue is that the shortfall in terms of the size of the long-term funding market differs widely across countries. In currency areas where banks have a large shortfall relative to the available supply, the long term debt markets might need to expand significantly to meet the additional demand by banks.

Outlook for bond markets and regulatory issues

Term funding markets may expand in response to increased supply by investors and the presumably higher yields. It could make short-term investors willing to make longer term investments, particularly if the market liquidity of long-term paper improves relative to shorter-term paper. This could be stimulated by transparent, collateralised and straightforward asset structures. For these reasons covered bonds have become popular recently, although we are not sure on the precise impact on unsecured investors. In the first quarter EUR 100 billion of covered bonds was issued in Europe and observers expect this asset class to grow further. The recognition as liquid assets in the LCR supports the issuance of covered bonds. As you probably know, MBS securities are not recognised in the LCR buffer. Increased transparency and market liquidity, for instance through market quotation, would increase the likelihood that MBS securities would be recognised as liquid assets.

Bonds yield might also be influenced by new resolution regulation that gives authorities more options to deal with ailing institutions. Market participants fear that this might raise the probability of burden sharing by bond holders. I guess this primarily concerns Tier 2 debt. Since that is a limited portion of total funding – at least for Dutch banks – there is little reason to worry. More in general, a rise in the yield on such bonds could be welcome if it implies a more adequate pricing of the risks that holders of bank bonds face.

Steady state

Assessing the long term market impact of Basel III is difficult, since banks may change their business models. It is likely that banks will look for more capital and liquidity efficient models, for instance by offering products with a more stable or fee-based income stream. This will change their capital and liquidity needs and thereby their reliance on financial markets.

It is clear that in the new steady state we will end up with a stronger banking system. The Basel Committee has estimated that if bank capital increases from 6 percent to 8 percent of the risk-weighted assets, the risk of a crisis is more than halved. If liquidity risk is also reduced, the probability of a crisis declines even more. The reduced default risk of banks will lower credit risk premia they have to pay in capital markets. Moreover, a stronger banking system is expected to have a positive impact on market confidence, reducing thus the volatility in financial markets.

Addressing the SIFI problem

I would also like to mention some developments that are not included in Basel III but that are high on the international agenda of financial policy makers. The crisis has taught that a targeted approach to systemically important institutions, so-called SIFIs, is crucial to safeguard financial stability and mitigate moral hazard. For a country like the Netherlands – a small open economy with a number of very large and interconnected financial institutions – addressing this problem is even more important. These institutions play a vital role in the Dutch financial system and real economy.

In order to tackle the SIFI problem the Basel Committee together with the Financial Stability Board are working on additional measures for systemic banks. These measures first involve more intensive supervision and a higher loss absorbing capacity, primarily to reduce the probability of a default of a systemic bank. This will mean that possibly systemic banks will be required to hold larger capital buffers.

Secondly, the measures involve improving the resolution capacity of national authorities and the requirement for systemic banks to develop recovery and resolution plans. This should help to make it easier to wind down any type of institution in an orderly fashion which will reduce the impact of a failure of a systemic bank. Moreover, the Basel Committee is working on a proposal for a methodology to identify systemic banks. A distinction will be made between domestic and global SIFIs, and stricter rules will apply to the latter group of institutions. Let me be clear, we are not talking about hundreds of banks, but rather a few dozens, which because of their size, interconnectedness, or limited substitutability could pose a risk to the international financial sector. This will help secure that at least the externalities associated with those institutions that are most interconnected on a global scale will be addressed.

The temporary changed role of central banks

Besides Basel III, the financial markets have been influenced significantly by the activities of central banks. Their role has dramatically changed in the crisis, owing to the unconventional policy measures, which are meant to be temporary. In autumn 2008, enhanced credit support to the interbank market was introduced in the euro area, by way of unlimited liquidity supply to banks against adequate collateral. This has supported monetary transmission and prevented a credit rationing of the private sector. For the same purpose, the Eurosystem purchased covered bonds issued by banks on a limited scale. This program has already been completed last year.

In May 2010, when the sovereign debt crisis erupted, the phasing out of the extended refinancing operations was temporary delayed and the Securities Markets Programme started. This bond purchasing program aims at non-functioning Eurozone bonds markets.

The Eurosystem buys bonds from monetary counterparties, while the liquidity creation is sterilised by the issuance of term deposits. The program has prevented that bond markets collapsed due to a drying up of market liquidity. It has supported the transmission of the policy rate to longer term interest rates in bond markets.

The Eurosystem has purchased EUR 77 billion government bonds of EMU countries so far, which is a substantial share of the government bond markets in the most affected countries. This is an unhealthy situation, since it creates an undesired dependence of governments on the central bank. Moreover, an extended government bond portfolio of the Eurosystem is not desirable from a risk management perspective.

The European debt crisis

Given the fact that monetary policy has been fully stretched, it is crucial that governments take their responsibilities to tackle the root causes of the sovereign debt crisis. To this end, Europe and the IMF established the European Financial Stability Facility (EFSF), an ultimate safety net that could be resorted to if needed, as Ireland did in November. It is important that governments keep improving the EFSF in terms of both quantity and quality, meaning maximum flexibility in the intervention of the EFSF. To be effective in supporting market confidence and prevent a further escalation of the crisis, a convincing increase of the level of available capital in the EFSF is desired.

The European Stability Mechanism (ESM) will replace the EFSF in 2013. Last month the European Council agreed that the ESM will have an effective lending capacity of EUR 500 billion. By exception, the fund will be able to buy sovereign bonds in the primary market. Debt purchases in the secondary market remain impossible, which I regret, since it complicates a transition of responsibilities from central banks to governments.

Any financial assistance to be granted under the ESM will be subject to strict conditionality and provides for involvement of private creditors in the unexpected event of insolvency, in line with IMF policies. To facilitate this process, from June 2013 onward, standardised collective action clauses (CACs) will be included in newly issued bonds with a maturity longer than one year. Moreover, the ESM gets a preferred creditor status, junior only to the IMF. These elements have made investors nervous, but probably markets will get used to them. They could enhance the disciplining market influence on sovereign debtors, although conditions to involve the private sector should be flexible, to prevent a disruption of market access by sovereigns and to prevent that credit spreads correct too abruptly.

Finally, I would like to stress that the European authorities, including the Eurosystem, do everything to stem the sovereign debt crisis. Countries conduct rigorous economic reform programs: to regain the trust of financial markets, improve economic growth, restructure banking sectors and strengthen public finances. These measures contribute to a more sustainable debt situation, although the challenges are huge in certain countries. The ESM will only reinforce the need for fiscal and macro economic discipline and stronger governance with more automatic mechanisms. The alternative of default would have much graver consequences, with unforeseen, but probably serious first and second round effects on the financial system across the euro area. This is precisely what policymakers are preventing with unprecedented measures.